COUNCIL AGENDA: 6-22-04
ITEM:

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Carl W. Mosher

SUBJECT: **SEE BELOW**

DATE: 6-1-04

Approved | Date

SUBJECT: PROPOSED SEWER SERVICE AND USE CHARGES AND STORM SEWER SERVICE CHARGES FOR FISCAL YEAR 2004-05

RECOMMENDATION

1. Hold public hearing on proposed FY 2004-05 Sewer Service and Use Charges and proposed maximums for rate increases in FY's 2005-06 and 2006-07; adopt resolution setting the rates recommended by staff for FY 2004-05; and direct staff to return during the FY 2005-06 and 2006-07 budget cycles with recommendations for rate increases in FY 2005-06 and 2006-07, consistent with the staff recommended maximum rate increases for those years; and

2. Approval of the staff proposed 4.5% rate increase for FY 2004-2005 in Storm Sewer Service Charges and adoption of a resolution setting the rates recommended by staff for FY 2004-2005.

BACKGROUND

Each year, the Council reviews the rates for Sewer Service and Use Charges (SSUC) and the Storm Sewer Service Charges (SSSC), to determine whether adjustments are necessary to align revenue with program costs. The uses for which SSUC revenue can be allocated are restricted by Municipal Code Section 15.12.450 to "the acquisition, construction, reconstruction, maintenance and operation of the sanitary sewer system of the City of San Jose; as well as the principal and interest on any bonds, loans, and advances for the construction of the system." The purposes of the SSSC, as stated in Municipal Code Section 15.16.1250 are: "for the acquisition, construction, reconstruction, maintenance, and operation of the storm drainage system of the City of San Jose, to repay principal and interest on any bonds, loans and advances and for any other purposes set forth in Section 15.16.1430."

Because of County billing system limitations, these two charges are billed as a single line amount on property tax assessments. The revenue received by the City is deposited to the SSUC and SSSC funds based on the rates established for the respective charges. This memorandum

presents separate descriptions of the proposed rate structure for the SSUC and SSSC.

ANALYSIS

SEWER SERVICE AND USE CHARGE

On May 7, 2004, Public Notices were sent to over 213,000 Sewer Service and Use residential and non-residential customers advising them that the Administration would recommend to Council an average SSUC rate increase of 4.5% for FY 2004-05, and that a Public Hearing would be held on June 22, 2004. If approved, the rate increase would become effective July 1, 2004.

The Public Notice also covers proposed SSUC for additional amounts up to 4.5% per year for services beginning July 1, 2005, and July 1, 2006. It should be understood that the analysis in this memo is for FY 2004-05 rates only, and that recommendations for any rate adjustments for FY's 2005-06 and 2006-07 will be submitted to Council for policy direction and adoption as part of the budget process for those years. Council action in FY's 2005-06 and 2006-07 will be subject to the maximum increases stated in the notices that were mailed on May 7, 2004, unless a new notice is mailed before rates are adopted for those years.

The average rate increase recommended for each major customer category for FY 2004-05 is:

Category	**% Increase**
Single-Family	4.49%
Multi-Family	4.43%
Mobile Home	4.43%
Commercial/Industrial	4.63%
Large Monitored	3.90%

These recommendations would increase the single-family monthly rate by $0.85 from $18.96 to $19.81 and the multi-family and mobile home monthly rate from $10.85 to $11.33. Rates in this fund were last increased ten years ago, in FY 1994-95, when rates were increased by 9%, or $1.57 per month for single-family residences. Since then, the single-family monthly rate has remained at $18.96. The proposed SSUC rates for FY 2004-05 are included in this document as Attachment A.

Rates are based on the volume of flow and the strength of the wastewater from residential, institutional, commercial, and industrial properties. Flow is measured as the average wastewater flow, and strength is measured in terms of biochemical oxygen demand (BOD), suspended solids (SS), and ammonia (NH_3). The rate structure was designed to apportion the cost of wastewater

treatment services to properties in proportion to their relative contribution of flow and strength to the system. This structure allows rates to reflect the costs of providing service to residential and non-residential properties.

Rates are assigned by groupings, based on the type of use. Residential customers are assigned a flat rate. Rates for most non-residential customers are based on winter water usage and flow strength. A small number of industrial users are billed on a monthly basis based on actual wastewater discharge and flow strength.

Non-residential customers are defined as institutional, commercial, or industrial and are classified into one of 22 customer classifications, including a miscellaneous class. Each customer's rate will vary depending on its class. More than half of these customers (approximately 5,600) are classified as "Miscellaneous," because they do not properly fit into one of the other customer classifications. In order to reduce the number of customers in the miscellaneous classification and create more equity among customers in this and other classes, it is recommended that an additional 37 classifications be added. Because of the volume of non-residential customers classified as "Miscellaneous," reviewing and reclassifying existing accounts would be extremely labor intensive. Therefore, the Administration proposes that the new categories apply to new accounts opened after July 1, 2004; to existing accounts that are reclassified after July 1, 2004; and to all other existing accounts on June 30, 2007.

The proposed Sewer Service and Use Charge rates are consistent with the Mayor's Budget Strategy recommending the general principle to focus on protecting vital core city services.

Funding Sources

The proposed rate increases, combined with projected interest earnings and penalties, installation fees, miscellaneous revenue, and fund balance are expected to generate $78.6 million in total sources for the Sewer Service and Use programs. The following is a summary of funding resources utilized to support sewer service and use related operations:

Source	2004-05 Proposed
Sewer Service and Use Fees	$71,551,157
Interest and Penalties	445,896
Installation Fees and Miscellaneous Revenue	41,300
Transfers	52,000
Fund Balance (Reserves)	6,557,063
Total	**$78,647,416**

During the past three fiscal years, the SSUC Fund has experienced flat or declining revenues, which can be attributed to two primary factors. First, the downturn in the economy has slowed the system growth rate as new development is down and the residential growth rate is below 0.5%. Second, and more significantly, industrial and commercial migration from the area has substantially reduced revenues from these sectors. Specifically, 3.5% of the decreased revenues are the result of six large industrial users that closed their operations in San Jose during the past four years, accounting for $2.6 million in lost annual revenue. The combined impact of the economic slowdown and commercial and industrial migration over the past several years has reduced revenues equivalent to a 6% decrease from the highpoint in FY 1998-99.

Fund Balance

The Administration's goal is to maintain a SSUC Fund reserve of 15% of operating expenditures (approximately $12 million) to meet large unanticipated costs or emergencies. Since 1998, expenditures have exceeded revenues, resulting in the use of fund balance to cover expenses. Even with the recommended rate increase, the fund balance will drop below the fund reserve goal in FY 2004-05.

Program Expenditures

The Sewer Service and Use Program costs for FY 2004-05 are detailed in the Special Fund Section of the 2004-05 Proposed Operating Budget, pages X38 through X44. As can be seen from the budget document, program expenditures have risen over the past six years, reflecting a number of contributing factors. Personal services costs have increased annually, reflecting the cost of living adjustments of the various City bargaining units. Additional increased operating costs include supplies, insurance, and vehicle and infrastructure maintenance.

There have also been significant increases in non-personal expenses required for the operation and maintenance of the Plant. Over the past twenty years, the Plant has decreased its energy consumption through operating efficiencies and process improvements. However, energy costs have risen 50% over the past 5 years, increasing the Plant's energy expenditures by $1.5 million, despite the Plant's reduced energy consumption. Although the Plant has a co-generation facility and supplies approximately 25% of its own energy, it still must purchase a portion of its power (natural gas and electricity) from the grid.

Heightened security concerns following September 11, 2001 have also required additional expenditures to ensure the safety and security of the Plant and the adjacent communities. Physical modifications to the Plant were implemented to prevent unauthorized access to the grounds and buildings and enhance overall infrastructure security.

Also related to security, the Plant has been evaluating alternative disinfection methods to end the Plant's dependence on gaseous chlorine as the primary source for disinfecting wastewater and converting to a less volatile chemical storage and treatment process. All alternative disinfection methods, however, are more costly than chlorine and significant infrastructure modifications will

be required in order to contain the alternative disinfection chemicals. Beginning in 2004-05, $5 million has been budgeted in the Five-Year Capital Improvement Program to address these modifications. In addition to the capital investment required, operating costs are projected to increase by approximately $3 million per year primarily due to the higher volume of alternative disinfectant required and increased chemical costs of an alternative treatment process over the existing chlorine system.

As operating expenses are increasing, the Plant's capital infrastructure needs are also becoming more critical. Over 50% of the Plant's infrastructure exceeds 30 years of age, reflecting the expansion to an advanced wastewater treatment facility in the early to mid 1970's. Consequently, much of this infrastructure and major equipment is nearing the end of its useful life and is in need of significant repair or replacement. The two major projects critical to ensuring the ability of the Plant to sustain its operations, particularly during peak flow incidents, are the Plant Reliability Improvements Project and the Plant Electrical Reliability Improvements project.

The Plant Reliability Improvements Project will construct an additional head works, add an emergency overflow basin, provide improvements to the filtration system, and upgrades or replacements of major pumping systems to ensure the Plant will be able to handle high wet weather flows without flooding, sewer backups, or compromising the treatment process. When completed, the Project will increase the Plant's peak wet weather flow capacity from 271 mgd to 400 mgd. The Project is in the final stage of design with the construction phase budgeted for FY 2004-05 at a cost of $55 million.

The Plant Electrical Reliability Improvements project will replace much of the electrical system infrastructure, which is deteriorating and, in the event of failure, would jeopardize the operations of the Plant. The Plant requires electricity 24 hours per day, 365 days per year and has a complex and extensive electrical system. Rehabilitation of the over thirty-year old electrical distribution system is essential to maintain the safety, security, and operational ability of the Plant. This project is scheduled to begin in FY 2004-05 with a total estimated cost between $40 - $60 million over ten years.

For FY 2003-04, expenditures will exceed revenues for the fifth consecutive year. In order to minimize the magnitude of proposed rate increases, the Environmental and Utility Services CSA will generate expenditure savings in FY 2003-04 through encumbrance liquidations and departmental savings totaling approximately $10 million. For FY 2004-05, to further offset future rate increases, a number of ongoing budget reductions are proposed. These include: a 10%, or $1.6 million decrease in the transfer to the Sanitary Sewer Capital Fund; a $911,000 reduction in the Water Efficiency Program; reduced marketing expenses ($285,000); contractual services reductions ($180,000); and other miscellaneous efficiency savings ($120,000). The ongoing budget reductions proposed for FY 2004-05 total over $3 million annually.

Proposed Rate Increases

SSUC rates have not been increased in ten years and the fund is now at the point where it is in critical need of increased revenues in order to sustain the viability of the SSUC Fund and the other sanitary sewer and wastewater treatment funds. Additionally, there are critical capital needs resulting from the aging infrastructure of the Plant that must be addressed to ensure the operational reliability of the Plant.

In order to maintain the fund's viability and solvency, sustain sewer and treatment system operations and maintenance, and address critical infrastructure rehabilitation needs, rate increases of up to 4.5% in each of the next three years are proposed. These increases would generate additional revenue of $3 million in FY 2004-05 and over the course of the three years, would bring in an additional $10.3 million. Combined with the $12.6 million in planned savings and proposed expenditure reductions, the total additional available funds after the three years would be $22.9 million.

Although the expenditure savings and proposed reductions ($12.6 million) will generate over half of the additional funds resulting from the combined strategy, rate increases are still needed.

During FY 2006-07, the third year of the recommended rate increases, ESD will re-evaluate the SSUC fund's needs for FY 2007-08 and beyond to determine whether additional rate increases will be needed in order to fund operating and capital needs and maintain an unrestricted ending fund balance of at least $12 million.

STORM SEWER SERVICE CHARGE

FY 2004-05 is the third year of a three-year rate increase strategy approved by Council to provide additional funding for the Storm Sewer Capital Improvement Program. On May 10, 2002, Public Notices were sent to over 213,000 Storm Sewer residential and non-residential customers advising them that the Administration would recommend to Council an average SSSC rate increase of 4% for FY 2002-03. The Public Notice also covered proposed SSSC for additional amounts up to 4.5% per year for services beginning July 1, 2003 and July 1, 2004. Council action for the FY 2004-05 rate increase is subject to the maximum increases stated in the notices, unless a new notice is mailed before rates are adopted for that year.

Council accepted the Administration recommendation to adjust the SSSC rates for FY 2002-03 according to the Public Notice and directed staff to implement the new rates. Council also accepted the Administration recommendation to adjust the SSSC rates for FY 2003-04 and directed staff to return during the FY 2004-05 budget cycle with recommendations for a rate increase for FY 2004-05. If approved, the rate increase would become effective July 1, 2004. The average rate increase recommended for each major customer category for FY 2004-05 is:

Category	% Increase
Residential	4.4%
Institutional	4.5%
Commercial	4.5%
Industrial	4.5%

These recommendations would increase the single-family rate by 16 cents monthly (from $3.66 to $3.82). Proposed SSSC rates for FY 2004-05 are included in this document as Attachment B.

Rates are based on the relative quality and quantity of storm water runoff contributed by residential, institutional, commercial, and industrial properties. The rate structure was designed to apportion the cost of storm sewer service to properties in proportion to their relative contribution of flow and pollution to the system. This structure allows rates to reflect the costs of providing service to residential and non-residential properties.

Rates are assigned by groupings, based on the type of use. Residential customers are assigned a flat rate. Rates for all other uses including commercial and light industrial, heavy industrial, parking lots, schools, churches, and colleges are calculated individually. Rates for these parcels include a charge based on acreage plus a flat charge reflecting runoff characteristics.

The proposed Storm Sewer Service Charge rates are consistent with the Mayor's Budget Strategy recommending the general principle to focus on protecting vital core city services.

Funding Sources

The primary source of funding in the Storm Sewer Operating Fund is storm sewer charges, which account for 99% of the revenues in this fund. The proposed rate increase of 4.5% is projected to provide an additional $620,000, bringing total FY 2004-05 revenues to $14.5 million. These funds have been allocated to the storm capital program as prescribed when the rate increases were approved.

Program Expenditures

Storm sewer operating expenses have been gradually increasing since FY 2001-02 due to increases in personal services costs and increased permit compliance costs. The rate increases approved by Council in FY's 2002-03 and 2003-04 were designated specifically to fund the storm sewer capital program. None of the additional revenue generated by the rate increases was used to support the increased operating costs. Instead, funds have been redistributed from other program areas to support the increased costs. Additionally, the use of fund balance reserves was required in order to fund program activities.

For FY 2003-04, savings of $505,000 are projected to accrue by year-end. These savings are primarily the result of expenditure reductions and encumbrance liquidations in order to fund permit compliance activities, storm pump station improvements, street sweeping effectiveness, and cost shifts from the General Fund in FY 2004-05. As part of the FY 2004-05 budget, an additional $152,000 in savings will be generated through ongoing budget reductions.

For FY 2004-05, several critical service needs were identified and are included in the Environmental and Utility Services CSA Investment Strategy or adjusted in the base budget.

Significant additions include:

- Capital Projects - $500,000 is proposed to be transferred to the Storm Sewer Capital Fund for storm pump station replacements and rehabilitation. This will begin to address the aging storm sewer infrastructure by replacing or rehabilitating the oldest and least reliable pump stations to reduce the risk of flooding;

- Permit Compliance Activities – Two additional inspectors were shifted from other program areas to perform inspections required by the new permit ($200,000 offset by non-personal reductions), and $100,000 was added for Offsite C3 implementation and engineering support;

- Street Sweeping - $120,000 is proposed (combined with another $120,000 from the Integrated Waste Management Fund) to fund expanded parking restriction enforcement on street sweeping days in targeted neighborhoods; and

- General Fund Reductions - $200,000 in storm response expenses can appropriately be charged to the Storm Sewer Operating Fund and will be shifted from the General Fund.

Despite all of the reductions proposed or already implemented to partially offset the proposed increases, approximately $1 million in fund balance will be needed to cover the additional costs. However, due to unanticipated savings in FY 2002-03, the FY 2003-04 ending fund balance is approximately $600,000 higher than the Adopted Budget estimate and can adequately fund these additional costs.

Future Expenses

As noted above, FY 2004-05 is the last year of the three-year rate increase package approved by Council in FY 2002-03. However, the repayment of the loan from the Sewage Treatment Connection Fee Fund 539, which was deferred beginning in FY 1997-98 to cover operating expenses, is scheduled for repayment between 2005-2008.

The additional revenue generated by the approved three years of storm sewer service rate increases is earmarked for the capital program. Without the renewal of the three-year rate package, the transfer to the Storm Sewer Capital Fund will be reduced to $1 million in FY 2005-

06 and $625,000 in subsequent years. This level of funding is inadequate to address the storm sewer infrastructure needs. For FY 2005-06, the Environmental and Utility Services CSA will be bringing forth a recommendation for an additional multi-year rate increase package to address this funding shortfall.

COORDINATION

This memorandum has been coordinated with the Departments of Public Works, Transportation, and Finance as well as the Offices of the City Attorney and City Manager.

CEQA

Not a project.

CARL W. MOSHER
Director, Environmental Services Department

Attachments